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PACKAGED RETAIL INVESTMENT PRODUCTS

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT REPORT

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EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT REPORT

'Packaged retail investment products' provide retail investors with easy access to financial markets. The regulatory framework for these products must provide a robust and coherent foundation for effective and responsible retail investment. The financial crisis has provided a stark reminder of the importance of transparency in financial products and of the potential costs of irresponsible selling. A collapse in investor confidence has underlined the urgency of ensuring the right regulatory framework is in place, so that the rebuilding of confidence can occur on a sound basis.

Throughout the European Union, a range of 'packaged' investment products are marketed to retail investors, offering the prospect of financial returns over the medium to long term, based on a combination of exposures to financial markets. These products include:

- investment funds;
- structured securities;
- unit-linked life insurance policies; and
- structured term deposits.

The overall market for these products is very significant, estimated at up to €10 trillion by the end of 2007, though the amount invested has fallen under impact of the financial crisis.

These products take distinct legal forms but provide comparable economic functions for retail investors. In a well-functioning market, competition between families of packaged retail investment product can promote an efficient allocation of resources, by creating incentives for producers to develop and sell products that provide a good match for the profiles of prospective investors.

The markets for these products are however characterised by steep asymmetries in information between product originators and distributors on the one hand and retail investors on the other, and principle-agent conflicts for those selling to retail investors. These market failures give rise to investor detriment at the micro-level, when products are mis-sold or mis-bought. At the macro-level there is the potential for investors to migrate away from the investment markets, with serious implications for those markets and the ability of individuals to provide for their financial futures.

Regulation has been put in place at European and national level to mitigate these failings. There are two central planks which are common across this regulation: ensuring investors get effective pre-contractual product information, and ensuring sales processes are fair. Such regulation at the European level has evolved on a largely sectoral basis. Applicable rules vary according to the legal form of the product and the legal status of the person selling the

product. In some sectors and for some products, there are no applicable rules at European level.

Effectively, there is a 'regulatory patchwork' at European level for different packaged retail investment products and the channels through which they are distributed.

This has already provoked widespread concern over the coherence of Community law. There are significant differences in the level of investor protection between industry sectors, as well as an 'unlevel playing field' for the originators and distributors of these products. In some Member States, supervisory authorities have, where permitted by Community law, acted to enhance investor protection and to level the playing field where they perceive that European requirements fall short.

However, these responses have been necessarily limited in their geographical scope and uncoordinated, leading to further divergence in rules and, at least in principle, an additional barrier to the development of a single market in these products.

In this Impact Assessment, two questions are considered: does this regulatory patchwork pose genuine risks of investor detriment and market distortion? If so, is a European level response necessary and what general form should it take?

Procedural Issues

The Commission's work on packaged retail investment products has its roots in an ECOFIN Council request in May 2007 for the Commission to examine the coherence of disclosure and distribution regimes in EU law applying to different types of retail investment product.

We have consulted extensively with stakeholders, including a written call for evidence in October 2007, followed by a Feedback Statement in March 2008, a technical workshop with industry representatives in May 2008, and a high-level Open Hearing in July 2008, which brought together over 300 senior representatives from industry, consumer associations, national regulators and the European institutions to discuss the development of the market and potential risks to retail investors.

To the extent that it is decided that action at the European level is needed, further impact assessment work would then be required to identify the specific measures necessary and the costs and benefits of these.

The impact of the general problem and the case for action at the European level

How has the general problem identified above manifested itself concretely? What are the costs to the EU economy and society, and who incurs these costs?

The absence of a coherent approach to disclosure and intermediary regulation at EU level translates into three problems:

- First, that the level of investor protection embodied in EU rules is not sufficiently high for all the products concerned.
- Second, that differences in EU rules distort competition in the market in favour of 'less regulated' products. Differences in EU rules may create incentives for 'regulatory arbitrage', thereby amplifying the risks of investor detriment described above.

- Thirdly, that divergent national approaches to disclosure and distribution resulting from uncoordinated Member State responses to gaps and inconsistencies in Community law increase barriers to cross-border trade and the development of a single market in packaged retail investment products, with concomitant impacts on the efficiency and size of the market.

Investor detriment can occur at both micro and macro levels. At the micro level, investors can lose money or make investments with faulty expectations as to likely returns; at the macro level there can be an erosion of confidence in retail investment markets. Regulatory arbitrage between product types can accentuate these impacts whilst undermining market competitiveness; given the additional impact of continued barriers to cross-border trade, an overall consequence would be increased inefficiency in the allocation of resources.

Expert opinion and anecdotal evidence from stakeholders support the view that these problems are in practice actually causing investor detriment, and to a lesser extent market distortions and reduced cross-border trade. Recurrent mis-selling and mis-buying across different jurisdictions indicates that risks are crystallising for investors.

Unilateral efforts of some Member States to address these risks through local regulations are a strong indicator of the strength and importance of these problems. Some Member States have also acted to reduce the potential for regulatory arbitrage between different distribution channels and types of product. Such unilateral action at the Member State is unlikely however to have much impact on the prospects for cross-border trade or overall standards of investor protection, given its limited geographical reach. Stakeholders have also indicated that a lack of coordination leads to additional costs for market operators distributing products in multiple Member States. The impact of interventions on cross-border trade may however be of less immediate importance, given that other factors can limit the scope for such trade for certain products.

Yet, even when the focus is placed solely on local markets, the regulatory patchwork at European level and the disparate positions at national level that flow from it are still likely to contribute to investor detriment and regulatory arbitrage. This is because Member State actions are constrained to a greater or lesser extent by Community law. The differences in approach within Community law inevitably lead to complicated regulatory patchworks between products within national markets. For this reason, gaps in investor protection and the existence of an unlevel playing field are European problems just as much or even more than they are local market problems.

The likely impact of taking no further action

Taking no action at the European level to address the above problems means that these problems would persist. This is not to say that the regulatory environment would remain unchanged. It is reasonable to assume that some Member States may take further action, in particular in light of the financial crisis. This may have a beneficial impact on the first two problems identified within the Member States in question, though constraints imposed by Community law could limit the overall scale of the impact.

Such action would also lead to further divergence of regulatory approaches across Member States, thereby potentially impeding market cross-border business and further complicating the legislative landscape. Also, it is unlikely that all Member States would take unilateral action, leaving some markets without adequate regulation.

It is also likely that self-regulatory initiatives would continue to emerge without further stimulus from the EU. There is also ongoing parallel work at EU level which mitigate the problems in certain sectors. (These include the review of the Prospectus Directive, and possibly other sectoral directives; the development of Key Investor Information for UCITS; work on improving financial education, in conjunction with Member States; and reviews of DMFSD and IMD. To these initiatives can be added any wider work on improving financial services regulation that is likely following the financial crisis.)

However, these initiatives could – without coordination – increase inconsistencies at the European level, and gaps in regulation would remain. The problems identified above would not be effectively mitigated across all Member States and market segments. In short, responses to the challenges identified in the Impact Assessment need to be informed by a coherent overall approach.

Objectives

Flowing from the problem analysis, the policy options are assessed in relation to their capacity to deliver:

- a high and consistent level of investor protection across all products and distribution channels, including those not currently subject to EU disclosure and distribution rules; investors should be able to make informed investment decisions and effectively compare different product offerings, whilst remaining confident in any investment advice they receive;
- a level playing field for all types of packaged retail investment product, including their distribution; and
- a strengthened single market in packaged retail investment products.

Option Analysis

A range of options for EU level action are identified and compared to the benchmark of no further intervention. The analysis is by necessity high-level and largely qualitative. Further detailed and granular impact assessment work will be necessary to support any agreed legislative follow-up work. This will include gathering further evidence.

Options are considered separately in relation to the two key regulatory areas identified (mandatory disclosures and selling rules). However, there are synergies between the two areas -- it is likely that a package of options that combines measures on pre-contractual disclosures and selling practices would have greater benefits than either examined in isolation.

The options identified and analysed in both areas are:

- no policy change;
- Commission promoted self-regulation;
- Commission Recommendation offering guidance on common principles and approaches;
- mandate to the Lamfalussy Committees to promote supervisory convergence; and

- EU-level legislative action.

The analysis underlines that options that do not include at least some element of legislative change at the European level would be incapable of fully addressing irregularities at the European level, and that this would limit benefits.

The comparison of options shows that self-regulatory initiatives are expected to achieve only marginal impact, whilst work through the Lamfalussy Committees or a Commission Recommendation could be expected to have greater positive effect. Legislative action promises the strongest positive impact, partly because it could be binding and better ensure a more coherent and efficient overall approach. Also, without legislative action differences between Member States and between industry sectors would likely remain, due to inconsistencies at the European level and weaknesses in coordination between actors within the industry and at the national level. While action that includes a legislative element would according to the analysis be most effective in delivering the identified objectives, the available options are not mutually exclusive.

Assessing the absolute likely scale of benefits is difficult at this stage. The impact assessment outlines the different mechanisms by which benefits can accrue and takes a qualitative view as to their relative weight. Incremental benefits are likely to vary significantly depending on the actual detail of follow-up action, so further impact assessment work is vital.

On the cost side, changes to disclosure activities or selling practices carry potentially significant compliance and administrative costs for firms; options are likely to vary in relation to their cost impact on other bodies such as national supervisors, the supervisors' committees and the Commission itself. A separate impact assessment on the follow-up measures will be carried out at a later stage, containing precise measurement of administrative burden using the Standard Cost Model.

It is likely that the benefits of action would be greater where it is coordinated with other work, on financial education for investors, with the industry to ensure effective engagement with measures, and with national regulators to ensure there is effective and coordinated supervision.

Conclusions

A key challenge in the aftermath of the financial crisis will be to rebuild consumer confidence in financial markets. A high level of product transparency and of professionalism in the financial sector will be essential if this challenge is to be met. As such, it is imperative that the European regulatory framework for packaged retail investments reflects the realities of modern financial markets and that a lack of coherence resulting from out-dated regulatory silos does not impede the delivery of a high level of investor protection and a level playing field for investment products across the EU.

This impact assessment has reviewed the regulatory landscape for packaged retail investment products at European level and has outlined clear differences in rules on pre-contractual disclosures and selling practices between products and sectors. It has not been possible with available evidence to be precise as to the scale of problems arising from this fragmented regulatory framework. However there are suggestive examples of investor detriment and qualitative evidence from a range of stakeholders on the impact of gaps and inconsistencies in Community law.

While some Member States have attempted to address these issues within their own territories, this has not been systematic across all Member States or co-ordinated between them, leading to further fragmentation of the regulatory framework, with potential impacts on cross-border service providers and hence the single market. Further, action at Member State level cannot wholly address regulatory inconsistencies at European level.

Consumer detriment, distorted competition between product families on the basis of regulatory arbitrage, and, to a lesser extent, barriers to the development of the single market will remain as significant problems in the absence of legislative action at the European level. A high-level analysis of options suggests that such action will incur material costs but would also drive benefits across all these areas.

On this basis, legislative action is recommended, in relation to both pre-contractual disclosures and selling practices.

This Impact Assessment has evaluated the need for legislative action to remedy identified deficiencies. It does not consider the precise form and content of any relevant measures. A thorough assessment of costs and benefits will require clear specification of the type of intervention under consideration, which will depend on follow up work to the forthcoming Communication. Considerable further work would be required to ensure a legislative response is effectively targeted and strikes an optimal trade-off between costs and benefits.